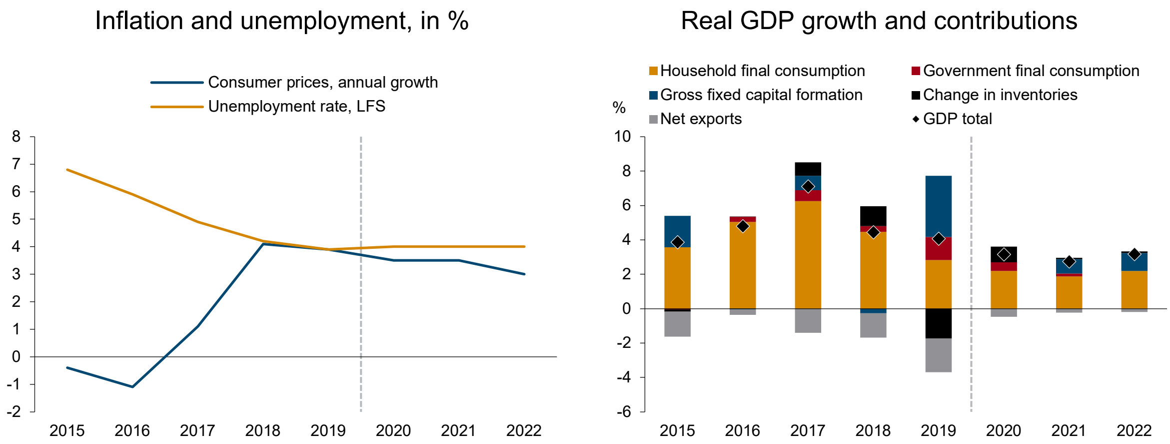
ROMANIA: Slowdown and twin deficits

GÁBOR HUNYA

The Romanian economy is emerging from a period of overheating and has to tackle high fiscal and current account deficits. Economic growth will cool from 4.1% in 2019 to 3.2% in 2020, and then 2.8% in 2021. Abundant financial inflows will allow a slow reduction of the twin deficits, but with increased vulnerability to financial turbulence. Political instability is expected to continue until general elections, expected to take place in mid-2020, ahead of schedule.

Figure 6.17 / Romania: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Three consecutive years of economic overheating in Romania came to an end in 2019. During the period 2017-2019, the country's GDP grew by 16%; real net wages by as much as 35%; and investments by a more modest 20%. GDP growth was driven by public consumption and household demand; gross fixed capital formation became buoyant only in 2019, while foreign trade had a negative impact on growth. The economy received a fiscal stimulus in 2019 in the shape of increased public-sector wages and investments. These raised the general budget's cash deficit to 4.6% of GDP, while government consumption grew by some 8%. Household consumption expanded much less in 2019 than in previous years, but rapidly rising wages meant that the figure was still 4.5%. Gross fixed capital formation grew by some 17% and was the main driver of economic growth last year. Investment projects that had contributed to expanding inventories the previous year were completed in 2019. Booming domestic demand generated a growth in imports that far outstripped export growth, so that the current account deficit widened to almost 5% of GDP.

The economy started to cool down in the middle of 2019. Both industry and agriculture recorded negative growth in the last two quarters, while construction and services remained buoyant. The expansion of exports slowed, but the same was not true of imports. Household consumption moderated only a little, as wages and consumer credit kept growing. Wage rises in early 2020 were moderate, and thus consumption is expected to ease in the course of the year.

Industrial production contracted in 2019 and may stay flat in 2020, if external demand remains weak. Manufacturing production and employment peaked in February/March 2019 and have declined since then. Those industrial branches with declining production were mainly the light industries, such as textiles and leather (which could not cope with the increasing wage demands of workers) and metal production (which was hit by international oversupply). The automotive industry could still expand its production on the basis of improved labour productivity. Agricultural production fell in 2019: in particular the autumn harvest was low, after three years of increased yields.

Companies are complaining less about labour shortages at the beginning of 2020 than a year earlier. Employment and unemployment rates have stabilised, and the vacancy rate has declined in line with the contraction of production in several industrial activities. But labour demand in construction is still high and the general concern of companies to find qualified workforce has remained.

The government took action in 2019 to moderate labour shortages in the short term by encouraging foreign workers. At the beginning of the year, it increased the number of work permits issued to non-EU citizens from 10,000 in 2018 to 20,000. After a further increase to 30,000 (also the current limit for 2020), 29,681 non-EU citizens held a work permit in November 2019. Although this number was only 0.035% of the labour force, it accounted for about 30% of job vacancies. The largest numbers of workers came from China, Turkey, the Philippines and Vietnam to work mainly in construction and catering. Since the beginning of 2019, employers have been obliged to pay them at least the average wage, rather than the minimum wage (as earlier). Thus, Romania has become a more attractive destination for temporary migration from less well-to-do economies. Emigration does not seem to have declined, despite higher incomes and better job opportunities: the wage gap between Romania and the advanced EU countries is still sufficiently wide.

Setting the minimum wage higher and higher was the main wage-policy tool of the former socialist (PSD) government, alongside public-sector wage hikes in 2018 and 2019. In 2020, the national liberal (PNL) government has tied the minimum wage rise to a formula that includes consumer price inflation plus productivity, adjusted by the expected rate of economic growth. The result is a gross minimum monthly wage of RON 2,230 for the current year – up from RON 2,080 the previous year; this constitutes a hike of 7.2% (after 10% in 2019), of which 4% compensates for inflation. The government has also initiated a more modest wage adjustment in the public sector than before. We expect about 5% real wage growth in 2020, implying slower growth in consumption.

Inflation rose to 4% in 2019, but is expected to drop back a little in 2020. Consumer prices have responded to soaring demand, driven by rapid nominal wage growth. Prices for food products and telephone services have increased the fastest. The RON has appreciated in real terms, moderating the consumer price increases (especially for imported non-food products). The Central Bank forecast is for inflation to ease in the near future; accordingly, it has maintained a stable policy rate of 2.5%. We perceive there to be a risk of an inflation–devaluation spiral in the event of an external shock.

The current account deficit deteriorated to almost 5% of GDP and the cash budget deficit to 4.6% in 2019 (about 4% in accrual terms). The budget deficit suddenly widened after the new government, which took office in November, paid all outstanding bills to the private sector and left most of the profits of state-owned companies in those enterprises. Unlike in earlier such situations, Romanian government bonds are selling well, albeit with a 4% yield in euro terms, and government debt is still below 40% of GDP. Rating agencies have not yet changed Romania's position. We perceive high risks for the rest of the year, due to a further widening of the fiscal deficit if public incomes policy remains loose and if the new pension act is implemented.

Pensions are due to be increased by 40% in September and child benefits are to double in August 2020. The fiscal effect would be 2% of GDP per year, and would dramatically increase the deficits in both 2020 and 2021. The law in question is a legacy of the former socialist government, and is rightly seen as a problem by the current national liberal interim government. But it cannot afford to take unpopular measures before the national elections, originally scheduled for November.

Early elections are regarded as a political solution to the public deficit drift. Were the liberal and conservative parties that support the current interim government to win elections before September 2020, they could postpone the pension hike or moderate it. (Our fiscal deficit forecast for 2020 – 3.5% of GDP – assumes limited implementation of the pension law.)

There are legal hurdles in the way of irregular elections, but the supporters of the PNL government and the president are determined to test the law to the limit. With just four months to spare, and by a decree that may be regarded as unconstitutional, the government changed the rules for the local elections that are due in mid-June 2020. This move led to a vote of no confidence, which the government lost. The reconstituted government needs to lose another vote of no confidence before the president can initiate an early general election. All this makes the political situation over the coming months rather strained. Rule of law and the institutional environment for investors will not improve until a government is confirmed by elections. As a positive outcome, we expect a stable, business-friendly, centre-right government to embark on a four-year spell in office later this year.

External and internal conditions will squeeze economic growth more than we forecast earlier – to 3.2% this year, and further to 2.8% in 2021. With this still moderate slowdown, we assume a soft landing based on modest pressure to consolidate the government budget, slowly diminishing excess demand and a related stepwise improvement in the external balance. Fiscal consolidation need not be drastic, despite the excessive deficit procedure expected to be initiated by the EU. The general government debt is still below 40% of GDP and may expand with no immediate punishment by the financial markets. The risks to smooth financing would be greater in the event of financial market turbulence or if the European Commission insists on an immediate fiscal adjustment. Under such conditions, economic growth may be squeezed more than our forecast. Accelerating inflation and a more rapid currency depreciation could be associated risks.

Future economic growth also depends on the sustainability of investments. After correcting for the boom last year with zero growth in 2020, gross fixed capital formation may start growing again on account of the modernisation needs of the private sector and the final tranche of EU funding in the current financing period. Romania can achieve 3-4% annual economic growth, provided labour productivity increases in the wake of modernisation investment.

Table 6.17 / Romania: Selected economic indicators

	2015	2016	2017	2018	2019 1)	2020	2021 Forecast	2022
Population, th pers., average	19,816	19,702	19,587	19,466	19,400	19,300	19,200	19,000
Gross domestic product, RON bn, nom.	712.6	765.1	857.9	952.4	1,050.0	1,140	1,220	1,310
annual change in % (real)	3.9	4.8	7.1	4.4	4.1	3.2	2.8	3.2
GDP/capita (EUR at PPP)	16,300	17,400	19,000	20,300	21,600	.	.	.
Consumption of households, RON bn, nom.	432.6	471.9	533.7	596.3	660.0	.	.	.
annual change in % (real)	5.9	8.3	10.1	7.2	4.5	3.5	3.0	3.5
Gross fixed capital form., RON bn, nom.	176.5	175.0	192.2	199.7	250.0	.	.	.
annual change in % (real)	7.5	-0.2	3.6	-1.2	17.0	0.0	4.0	5.0
Gross industrial production 2)								
annual change in % (real)	2.8	3.1	7.9	3.5	-2.3	0.0	2.0	3.0
Gross agricultural production								
annual change in % (real)	-6.8	2.6	12.5	7.2	-2.3	.	.	.
Construction industry 2)								
annual change in % (real)	10.5	-4.4	-5.5	-4.1	27.6	.	.	.
Employed persons, LFS, th, average	8,535	8,449	8,671	8,689	8,690	8,690	8,690	8,690
annual change in %	-0.9	-1.0	2.6	0.2	0.0	0.0	0.0	0.0
Unemployed persons, LFS, th, average	624	530	449	380	357	360	360	360
Unemployment rate, LFS, in %, average	6.8	5.9	4.9	4.2	3.9	4.0	4.0	4.0
Reg. unemployment rate, in %, eop	5.0	4.8	4.0	3.3	3.0	.	.	.
Average monthly gross wages, RON 3)	2,555	2,809	3,223	4,357	4,923	5,400	5,800	6,300
annual change in % (real, gross)	10.4	11.7	13.2	8.0	8.8	5.0	3.0	5.0
Average monthly net wages, RON	1,859	2,046	2,338	2,642	3,036	3,300	3,500	3,800
annual change in % (real, net)	10.1	11.8	12.8	8.0	10.7	5.0	3.0	5.0
Consumer prices (HICP), % p.a.	-0.4	-1.1	1.1	4.1	3.9	3.5	3.5	3.0
Producer prices in industry, % p.a.	-2.3	-1.8	3.5	5.1	3.8	3.0	2.0	2.0
General governm.budget, EU-def., % of GDP								
Revenues	35.5	31.9	30.9	32.0	32.5	32.5	32.5	33.0
Expenditures	36.1	34.5	33.6	34.9	36.5	36.0	35.5	36.0
Net lending (+) / net borrowing (-)	-0.6	-2.6	-2.6	-2.9	-4.0	-3.5	-3.0	-3.0
General gov.gross debt, EU def., % of GDP	37.8	37.3	35.1	34.7	37.0	38.0	39.0	39.0
Stock of loans of non-fin.private sector, % p.a.	2.5	0.9	5.3	7.9	7.0	.	.	.
Non-performing loans (NPL), in %, eop	13.5	9.6	6.4	5.0	4.0	.	.	.
Central bank policy rate, % p.a., eop 4)	1.75	1.75	1.75	2.50	2.50	2.50	2.50	2.50
Current account, EUR mn	-949	-2,348	-5,239	-8,961	-10,478	-11,500	-11,300	-10,900
Current account, % of GDP	-0.6	-1.4	-2.8	-4.4	-4.7	-4.9	-4.6	-4.2
Exports of goods, BOP, EUR mn	49,105	52,162	57,162	61,814	63,061	64,300	65,900	67,900
annual change in %	4.8	6.2	9.6	8.1	2.0	2.0	2.5	3.0
Imports of goods, BOP, EUR mn	56,896	61,475	69,365	76,617	80,422	83,600	86,100	88,700
annual change in %	6.6	8.0	12.8	10.5	5.0	4.0	3.0	3.0
Exports of services, BOP, EUR mn	17,173	18,880	21,730	23,791	26,323	28,400	30,700	33,200
annual change in %	10.0	9.9	15.1	9.5	10.6	8.0	8.0	8.0
Imports of services, BOP, EUR mn	10,355	11,000	13,544	15,431	17,771	19,200	20,500	21,900
annual change in %	8.4	6.2	23.1	13.9	15.2	8.0	7.0	7.0
FDI liabilities, EUR mn	3,885	5,656	5,225	6,205	6,120	6,000	.	.
FDI assets, EUR mn	.	1,143	348	1,259	859	500	.	.
Gross reserves of NB excl. gold, EUR mn	32,238	34,242	33,494	33,065	32,927	.	.	.
Gross external debt, EUR mn	94,709	94,273	97,446	99,841	106,000	113,000	115,000	117,000
Gross external debt, % of GDP	59.1	55.3	51.9	48.8	47.9	47.9	46.4	44.7
Average exchange rate RON/EUR	4.4454	4.4904	4.5688	4.6540	4.7453	4.83	4.92	5.00

1) Preliminary and wiiw estimates. - 2) Enterprises with 4 and more employees. - 3) From 2018 the employers' social security contribution was transferred to the employees; real growth 2018 refers to net wages. - 4) One-week repo rate.

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.